BEPS Action 7: how the OECD's proposals to redefine a PE could affect multinationals

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The OECD’s final reports on the Base Erosion and Profit Shifting (BEPS) Project aim to target aggressive tax planning strategies which have the effect of shifting profits from high tax jurisdictions to low tax jurisdictions. The BEPS Project has been divided into 15 Actions, of which one of the most far-reaching actions is Action 7 (Preventing the Artificial Avoidance of Permanent Establishment Status).

The purpose of Action 7 is to tackle common tax avoidance strategies used to circumvent the existing definition of permanent establishment (PE) via the use of agency or similar arrangements (eg commissionaire arrangements). Further, Action 7 aims to prevent the exploitation of the existing specific exceptions to the PE definition, in particular those relating to activities of a “preparatory and auxiliary” nature, an issue which is particularly relevant in the digital economy.

Current definition of permanent establishment

Under the current OECD Model Tax Convention, in general terms a PE could arise in the following two circumstances:

- where there is a fixed place of business through which the business of the non-resident company is carried on
- where there is a dependent agent of the non-resident concluding contracts on its behalf in that country.

Under the current PE definition, an agent in one country acting on behalf of an enterprise will only become a PE of the enterprise in that country if the agent has, and habitually exercises, authority to conclude contracts in the name of the enterprise, unless the agent is an independent agent acting in the ordinary course of its business. An agent is regarded as independent where it is legally and economically independent from its principal.

Key proposed changes

The key changes can be summed up as follows:

- Dependent agent PE - Strengthening the dependent agent PE rules so that a PE will arise not only where a dependent agent concludes contracts in the name of the enterprise, but also contracts for the transfer of, or for the granting of the right to use, property owned by that enterprise, or for the provision of services by that enterprise, where the agent habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the
enterprise

- **Independent agent** - Tightening the circumstances in which an agent would be considered as "independent" such that if an agent acts exclusively or almost exclusively for one or more enterprises to which it is closely related, it will not be an independent agent and

- **Specific activity exemptions** - The exclusion of certain activities (e.g., maintenance of stocks of goods for storage, display, delivery or processing, purchasing or the collection of information) from the definition of fixed place of business permanent establishment will only apply where the activities are preparatory or auxiliary in relation to the business as a whole.

**Dependent agent PE**

The new definition of dependent agent PE is much wider, so as to include the activities of an intermediary that results in contracts:

(i) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or

(ii) for the provision of services by that enterprise.

Previously, the definition only covered conclusion of contracts in the name of the enterprise. In applying this rule, a new concept has been introduced: rather than focusing on the agent's authority to conclude contracts, the test is that the agent habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise.

These proposed changes are aimed at tackling the use of commissionaire arrangements or similar structures to circumvent the existing definition of PE. The revised commentary provides some guidance and examples on the phrase "habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise." This phrase addresses situations in which the conclusion of a contract directly results from actions that the person performs in one country on behalf of the non-resident, even though the contract is not concluded by that person.

Therefore, this phrase would cover the actions of the enterprise's sales force – i.e., actions of a person who convinced a third party to enter into a contract with the enterprise – for example, when a person solicits and receives (but does not formally finalise) orders which are sent directly to a warehouse from which goods belonging to the enterprise are delivered and where the enterprise routinely approves the transaction. In contrast, when a person merely promotes and markets goods or services of an enterprise, and those actions do not directly result in the conclusion of contracts, then the marketing activity does not directly result in the conclusion of contracts, even though sales may significantly increase as a result.

The changes also narrowed the requirements for an agent to be considered "independent." Independent status is less likely when the agent acts exclusively or almost exclusively for one or more closely related enterprises. The revised commentary provides some guidance on these concepts – broadly, enterprises are closely related if there is direct or indirect control of more than 50 percent of the beneficial interests or de facto control. Where the sales concluded by an agent for closely related enterprises represent more than 90 percent of all the sales it concludes, this would fall within the phrase "exclusively or almost exclusively" for the purposes of the new independent test.

**Fixed place of business PEs and anti-fragmentation rules**

Because most businesses today are involved in digital sales one way or another, changes to the specific activity exemptions to fixed place of business PE are required to reflect the way in which businesses operate in the modern world. Activities which were previously considered preparatory or auxiliary in nature may constitute an essential part of an enterprise's business.

Under the current specific exemptions, a PE is deemed not to exist when a place of business is used solely for activities as listed in Article 5(4)(a)-(f). These include the use of facilities solely for storage, maintenance of stocks of goods for storage, display, delivery or processing, purchasing or the collection of information.

The proposed changes provide that:
the activities as set out in each of the exceptions under Article 5(4)(a)-(f) will now be subject to the condition that
the activities referred to therein be of a preparatory or auxiliary nature. Under the current definition, the first
four exceptions are not subject to the "preparatory or auxiliary nature" requirement.

the revised Commentary contains some useful guidance and examples as to what constitutes "preparatory or
auxiliary." For example, storage and delivery activities to fulfill online sales do not have a preparatory or
auxiliary character; whereas the storage of goods in a bonded warehouse during the custom clearance process
would be acceptable and

anti-fragmentation rules will be introduced to prevent the fragmentation of a cohesive operating business into
several small operations in order to get within the "preparatory or auxiliary" exemption. These rules will mean that
the activities of related parties will be viewed as a whole when determining whether such activities would still fall
within the "preparatory or auxiliary" exemption.

Some countries view the amendments to the specific activity exemptions above as unnecessary and hold that
artificial avoidance is adequately addressed by the adoption of the anti-fragmentation rules alone. The
Commentary therefore builds in an optionality allowing for this approach, which could lead to inconsistency in how
the proposals are adopted in different countries.

Other proposed changes

Other proposals include:

- Splitting up of construction contracts – splitting up contracts artificially into shorter periods of less than 12
  months in order to benefit from the "construction site" exemption should be prevented by applying the principal
  purposes test, proposed as part of Action 6 on the prevention of treaty abuse, or by a specific provision which
  aggregates the activities of closely related enterprises on the same site during different periods of time (each
  exceeding 30 days) for the purpose of determining the 12-month period.

- Profit attribution of PE – additional guidance on the determination of profits to be attributed to the PEs as a result
  of the revised definition of PE will be provided. The OECD aims to release such guidance by the end of 2016.

Implementation

The OECD has recognised that implementing the BEPS proposals will require modifications to the existing network
of more than 3,000 bilateral tax treaties worldwide. Therefore, it aims to create a "multilateral instrument" – a single
instrument allowing countries to update their tax treaties in a more efficient manner. It is anticipated that the final
form will be ready for signature by 31 December 2016. However, it is unclear at this stage how this would work in
practice, in particular how the optionality that is part of a number of other BEPS Actions will be accommodated
within this single multilateral instrument.

Additional compliance costs, administrative burdens, uncertainty

The proposed amendments to the definition of PE are far-reaching and will affect all businesses that carry on any
cross-border supplies. A certain level of subjectivity has been introduced into these proposed rules, which could
result in many permanent establishments being created even in cases where tax may not have been the main
driver behind the arrangements. While the existence of more PEs does not necessarily translate into a material
increase in tax exposure, especially where an arm's length amount is payable for the services received, there will
almost certainly be additional compliance costs and administrative burden for businesses in navigating themselves
around the new rules. Further, there could be an increase in the number of disputes between tax authorities when
allocating the primary taxing rights and the amount of profits attributable, which may increase uncertainty and
compliance costs for businesses, as well as result in double taxation.

Businesses should start reviewing their existing structures, identify whether group activities are likely to create PEs
under the proposal, and assess the impact of any potential new PEs on the business structures. The OECD’s
proposals should certainly be taken into account when entering into new arrangements and, to the extent required,
changes to any existing arrangements should also be considered in order to lessen any risks.

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